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Tax Reform Passes Lower House

After using its majority to force consideration of tax reform proposals by the lower house of the Diet, the Liberal Democratic Party turned to concessions and modifications to win the cooperation of opposition parties and pave the way for passage by the lower house November 16 of the six-bill package. The LDP then again used its majority to extend the special Diet session by 34 days until December 28 to give the upper house time to consider the legislation. Although lower house approval of the controversial tax reforms is considered a political victory for Prime Minister Noboru Takeshita, he is still concerned over the chances for upper house passage.

After nearly four months of negotiations, the LDP's package emerged from the lower house relatively unscathed. It envisions tax reductions of Y5.6 trillion ($44.8 billion at Y125=$1.00) in FY 1990, composed of changes in:

• National personal income taxes - Trimming the number of brackets retroactive to January 1, 1988 from 12 to five with a top rate of 50 percent for incomes above Y20 million ($160,000) compared with the current maximum of 60 percent for incomes over Y50 million ($400,000). Taxpayers at the low end also will benefit (see Table 1a): the bottom rate will drop to 10 percent from 10.5 percent and will apply to incomes of less than Y2 million ($16,000) instead of Y1.5 million ($12,000). Personal exemptions plus credits for dependents, senior citizens and handicapped people also will be increased starting January 1989 (Table 1b). In order to gain the cooperation of opposition parties, the LDP made two last-minute changes: the tax deduction for an invalid elderly will be raised from Y900,000 ($7,200) to Y1.2 million ($9,600); and the tax-exempt amount of retirement income will be raised from Y10 million ($80,000) to Y15 million ($120,000).

Table 1: National Personal Income Tax Changes

a. Tax Rates
(effective January 1, 1988)
(in millions of yen and percent)

1987			1988		
	Income	Rate		Income	Rate
Under	Y1.5	10.5%	Under	Y2.0	10.0%
Over	1.5	12.0			
	2.0	16.0	Over	2.0	20.0
	3.0	20.0			
	5.0	25.0			
	6.0	30.0		6.0	30.0
	8.0	35.0			
	10.0	40.0		10.0	40.0
	12.0	45.0			
	15.0	50.0		20.0	50.0
	30.0	55.0			
	50.0	60.0			

b. Credits
(effective January 1, 1989)

	1988	1989
1. Basic Exemption		
Spouse	Y330,000	Y350,000
Dependent	330,000	350,000
2. Additional Spousal Credit	165,000	350,000
3. Additional Exemption for Dependents, Ages 16-22	---	100,000
4. Special Exemptions		
Handicapped	250,000	270,000
Widow	250,000	270,000
Working Student	250,000	270,000

• Local personal income and residence taxes - Decreasing the number of brackets and cutting the maximum rate, also retroactive to January 1988 (see Table 2). Combined with the cuts at the national level, these changes will total an estimated Y3.1 trillion ($24.8 billion) in FY 1990.

Table 2: Local Income and Residence Taxes

(effective January 1, 1988)
(in millions of yen and percent)

	1987			1988	
	Income	Rate		Income	Rate
Income Tax					
Under	Y0.6	3.0%	Under	Y1.2	3.0%
	1.3	5.0			
	3.0	7.0			
	4.5	8.0		5.0	8.0
	9.0	10.0	Over	5.0	11.0
	20.0	11.0			
Over	20.0	12.0			
Residence Tax					
Under	Y1.3	2.0%	Under	Y5.0	2.0%
	3.0	3.0	Over	5.0	4.0
Over	3.0	4.0			

Table 3: Inheritance and Gift Taxes

(effective January 1, 1988)
(in millions of yen and percent)

	1987	1988
1. Minimum taxable inheritance		
Basic minimum	Y20	Y40
Statutory heir (per person)	4	8
2. Maximum inheritance tax rate	75%	70%

3. Entire legal inheritance of surviving spouse is exempt.

4. Number of adopted children will be limited to:
one if there is a natural child
two if there are no natural children

5. Land purchased up to three years before death will be valued at the transaction price, not the book value.

6. Special rates for small real estate holdings (less than 200 square meters)		
Residential	30%	50%
Business	40	60

• Inheritance and gift taxes - Reducing the top tax rates and increasing the minimum taxable amounts (see Table 3). Partly in response to the sharp increase in land prices over the past few years, the Tax System Research Council recommended the first significant changes in inheritance and gift taxes in 13 years. Retroactive to January 1, 1988, the top rate will be reduced to 70 percent from 75 percent on estates above Y500 million ($4 million) and gifts above Y70 million ($560,000). The minimum taxable estate and individual inheritance will double to Y40 million ($320,000) and Y8 million ($64,000), respectively.

• Corporate income taxes - Cutting the maximum corporate rate in two steps until it reaches 37.5 percent in FY 1990, compared with the present 42 percent maximum. The rate for small- and medium-sized businesses will drop from 30 percent to 28 percent by FY 1990 (see Table 4).

Table 4: Corporate Income Tax Changes

a. Tax Rates
(in percent)

	FY 1988	FY 1989	FY 1990
Basic Rate			
Reserves	42%	40%	37.5%
Dividends	32	35	37.5
Small- and Medium-Sized Firms			
Reserves	30	29	28
Dividends	24	26	28
Public Corporations*			
Reserve	27	27	27
Dividend	25	25	27

*Includes cooperative associations and other special organizations.

b. Other Changes

1. A portion of dividend income will be counted in gross receipts: 0 percent in FY 1988, 10 percent in FY 1989 and 20 percent in FY 1990.

2. The ceiling on the value of assets that can be fully depreciated in one year will be raised from Y100,000 to Y200,000.

3. Foreign taxes:

   a. Half of any foreign income not subject to foreign tax will be deducted from total foreign income, but the maximum ratio of foreign to total income is 90 percent.
   b. Foreign taxes paid above the usual level will not be deductible.
   c. The carryover period for losses or gains will be reduced from five years to three years.

In exchange for these reductions, the government hopes to raise by FY 1990 a net Y3.2 trillion ($25.6 billion) in revenues through the following changes:

• Corporate taxes - Keeping a closer watch on corporate tax returns and eliminating some tax exemptions by FY 1990, the tax office hopes to gain Y600 billion ($4.8 billion).

• Capital gains tax - Calculating the tax liability (at the taxpayer's discretion) by one of the following methods: 20 percent of the yield or 1 percent of the total value of the transaction (see Table 5). The impact of this change will be softened by lowering the securities transaction tax from 0.55 percent to 0.3 percent of the transaction value for stocks and from 0.26 percent to 0.16 percent for bonds. In response to the Recruit Cosmos Co., Ltd. stock scandal, the LDP also added taxes targeted at insider trading and initial private offerings. Combined with small changes in other personal taxes (such as tougher regulation of inheritance taxes), these alterations should bring in an estimated Y600 billion ($4.8 billion).

Table 5: Capital Gains Tax

1. Capital gains from securities transactions will be taxed in one of two ways at the taxpayer's discretion:
   a. Actual gains (gains minus losses in one calendar year) will be subject to a 20 percent central and a 6 percent local tax.
   b. One percent of the total transaction value will be withheld by securities brokers.

2. Restraint of insider trading:
   a. Gains from the public sale of stock within three years of its initial public offering will be subject to a 20 percent tax. This applies only to those who held the stock before the initial public sale.
   b. After the three-year period, half of any capital gain will be tax-exempt.
   c. Founders and officials of the company will be subject to an additional 1 percent tax if they profit from the public sale of their stock within one year of the initial public offering.

• General consumption tax - Adding a 3 percent tax on goods and services will raise an estimated Y5.4 trillion ($43.2 billion). Firms with annual sales of less than Y30 million ($240,000) will be exempt and those with sales under Y500 million ($4 million) will pay a reduced rate. Food will be exempt, as will a number of other transactions (see Table 6). A general consumption tax won over a value-added tax, such as that commonly used in European countries, because of the greatly reduced paperwork.

Most current commodity and other indirect taxes will be abolished, reducing revenues by an estimated Y3.4 trillion ($27.2 billion). A potentially important change for non-Japanese automakers is the decision to drop the 23

percent excise tax on full-sized cars and cut the tax on compact and minicars from 18.5 percent to 6 percent. The changes in the indirect tax structure will yield a net Y2 trillion ($16 billion) in revenue.

Table 6: Indirect Taxes

a. General Consumption Tax
(effective April 1, 1989)

1. A tax of 3 percent (6 percent for automobiles) for the first three fiscal years will be applied to all sales and service transactions (see exemptions below). Tax liability will be calculated by using existing bookkeeping records, not special invoices. Taxes will be due twice a year.

2. Small- and medium-sized businesses with sales of less than or equal to:
   a. Y30 million per year are exempt.
   b. Y500 million per year may use a fixed value-added rate of 10 percent for wholesalers and 20 percent for all others.

3. Exemptions: exports, land sales, securities transactions, foreign exchange deals, loan interest, parimutuel betting, postage stamps, medical expenses, education costs, and certain government administrative fees and social welfare payments.

b. Existing Indirect Taxes

1. The following levies will be eliminated: commodity taxes, playing card tax, sugar tax, admission tax, travel tax, electricity tax, gas tax and timber delivery tax.

2. The ad valorem tobacco tax will be abolished, but the specific tax will remain.

3. Taxes relating to petroleum will remain in place and petroleum transactions also will be subject to the general consumption tax.

4. Hotel, restaurant and local entertainment taxes will be substantially modified and subject to the general consumption tax.

• Alcoholic beverage taxes - Dropping the grading system for sake and wine, easing the grading system for whiskey and sharply reducing the levy based on alcoholic content (see Table 7). The tax on shochu, a popular local drink, will be raised by 75 percent to reduce the gap between levies on domestic and imported spirits.

In sum, the tax reform package will be stimulative, with total tax reductions outweighing increases by Y2.4 trillion ($19.2 billion). This is equivalent to 4.2 percent of the fiscal 1988 general account budget of Y56.7 trillion ($453.6 billion). Since the current budget is already 4.8 percent bigger than FY 1987's, the proposed tax changes will ensure that the public sector plays a positive role in Japan's overall economic growth at least through the end of the decade.

Table 7: Alcoholic Beverage Taxes

(in yen per kiloliter)

Product	Alcoholic Content	FY 1988	FY 1989
Sake			
Special	15%	¥570,600	¥133,700
Grade 1	15	279,500	133,700
Grade 2	15	107,900	133,700
Blended Sake	15	81,600	65,700
Shochu			
Grade A	25	78,600	119,800
Grade B	25	50,900	70,800
Mirin			
Regular	13.5	74,100	21,600
Fortified	22	63,500	34,400*
Beer	--	239,100	208,400
Wine			
Regular	--	159,800	46,300
Above grade	--	60,400	46,300
Below grade	--	49,700	46,300
Sweetened Wine	12	117,300	85,000
Whiskey			
Special	43	2,098,100	1,055,980*
Grade 1	40	1,011,400	982,300
Grade 2	37	296,200	908,620
Other Spirits	37	361,800	331,400
Liqueur			
Regular	15	367,000	106,270*
Other	12	117,300	85,000
Miscellaneous			
Distilled	--	239,100	208,400
Mirin-type	13.5	74,100	21,600
Other	12	117,300	85,000

*Base rate. Total tax will depend on actual alcohol content.

In addition to the changes in the tax treatment of invalids and retirement pay, Mr. Takeshita agreed to opposition appeals to administer the consumption tax "flexibly" between April 1 and September 30, 1989. This will probably mean that it will be phased in over this period. LDP secretary general Shintaro Abe also pledged that the LDP would try not to raise the consumption tax rate above 3 percent. On the political front, Mr. Takeshita agreed to opposition party demands for a new investigation of the Recruit Cosmos stock scandal. Fifty Diet members, drawn from all parties, will begin a fuller investigation of the matter as soon as possible.

Although the LDP holds a comfortable majority in the upper house, the opposition parties have returned to their delay-and-boycott tactics. No sooner had the 34-day extension been approved than the opposition parties began protest speeches in the Diet, halting all business. Opposition leaders want the

investigation of the Recruit Cosmos scandal to receive top priority over the tax bills. The LDP already expects the FY 1989 budget process to be delayed, although the Finance Ministry still hopes to finish compiling the budget by the end of this year. It will take still more negotiations and horse-trading before the LDP can push the tax bills through the upper house, but the package is almost certain to pass at this point.

Jon Choy

Currency Traders Feast On Strong Yen

While many currency traders had headed home for Thanksgiving, those who remained had a morsel of their own to chew on. For a few moments on the eve of the American holiday, Japan's currency rose to 121.03 yen to the dollar, its highest level in the past 40 years. For those with an interest in a strong dollar, it was a depressing way to begin a holiday -- but not without precedent: the yen's previous high had been set last New Year's Eve.

A reported $5 billion worth of dollar-support measures by the Group of Seven industrial nations over two days may have been behind a slight reversal as markets swung back to full activity after Thanksgiving. Would Americans get an early holiday gift in the form of a stronger dollar? Many analysts were skeptical, for several reasons.

- Japan's current account surplus and the U.S. deficit in trade, services and unilateral transfers both remain high. While the dollar's depreciation since 1985 has helped cut the twin imbalances, many experts are convinced that another round of exchange rate revisions is necessary.

- With a new administration set to take over in Washington, international economic policy is in a state of flux. Conflicting statements from those likely to wield influence have discombobulated the currency markets. Until the new team gets its bearings, traders are wary of committing themselves to dollar-denominated assets.

- The U.S. budget deficit remains a problem. The huge capital inflows that it brings in its wake have unsettling effects on currency markets. If, as is likely, constant flows of foreign money can be induced only by ever larger interest rate differentials, foreign investors face the risk not only of currency losses if they are in dollars at the wrong time but of capital losses resulting from rising interest rates.

Ironically, this does not suggest that progress on the budget deficit would necessarily lead to a stronger dollar down the road. A diminished deficit would reduce the demand for dollars on world currency markets and, other factors being equal, bring about a weaker dollar. At the same time, progress on the deficit would reduce the role of capital flows in exchange rate determinations, which would help stabilize the dollar, albeit at a lower level.

- Partly offsetting these factors is the belief that both oil prices and U.S. interest rates are heading higher. In the past rising oil prices have been good news for the U.S. currency if not the American driver. U.S. banks added a little support of their own for the dollar the week after Thanksgiving by raising their prime lending rates half a percentage point; this may attract some foreign short-term capital and thereby increase the demand for dollars.